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The Trust Indenture Act of 1939 in the Proposed Federal Securities Code

Richard A. Stark*

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I. INTRODUCTION

In 1974, when Professor Louis Loss¹ began fitting the Trust Indenture Act of 1939² (TIA) into the Federal Securities Code³ (Code), there was virtually no legal commentary indicating a need for substantive change in the technical trust indenture field.⁴ In 1958 the Securities and Exchange Commission (SEC) completed its unofficial Manual of the Trust Indenture Act of 1939 (SEC Manual),⁵ which still serves as the best available practical guide for understanding the most important provisions of the TIA. The SEC Manual contains many clarifications and interpretations, some of which have been reflected in the Code, but it does not disclose glaring statutory defects. Consistent with the views of most persons involved in this field, Professor Loss' *Introductory Memorandum* to Tentative Draft No. 2⁶ remarked that "little substantive change is envisaged" with respect to the trust indenture part of the Code. As the work on what is Part XIII in the Proposed Official Draft of 1978 (1978 Draft)⁷ progressed, however, two events occurred that caused reconsideration of certain aspects of the TIA's statutory scheme.

First, Associate Professor Howard Friedman of the University of Toledo Law School published an article⁸ in which he criticized the Code project for its apparent intention to make little substantive change in the TIA. Friedman was concerned about trustees' potential misuse of insider information, trustee-lenders' rights, and trustees' duties prior to default. To prevent the possible misuse of insider information by an indenture trustee, Friedman recommended

1. Professor Loss is the William Nelson Cromwell Professor of Law, Harvard University, and the Reporter for the Federal Securities Code project of the American Law Institute.

2. 15 U.S.C. §§ 77aaa-77bbb (1976) [hereinafter referred to as the TIA].

3. ALI FED. SEC. CODE Part X (Tent. Draft No. 4, 1975) [hereinafter cited as TD-4].

4. The following professional articles and student works were written about the TIA prior to 1974: Banks, *Indenture Securities and the Barkley Bill*, 48 YALE L.J. 533 (1939); Goodbar, *Bond Trustees as Statutory Trustees*, 28 B.U. L. REV. 399 (1948); Johnson, *Default Administration of Corporate Trust Indentures* (pts. 1-3), 15 ST. LOUIS U. L.J. 203, 374, 509 (1970); Katz, *Responsibility of Trustees Under the Federal Trust Indenture Act of 1939*, 26 A.B.A.J. 290 (1940); Palmer, *Trusteeship Under the Trust Indenture*, 41 COLUM. L. REV. 193 (1941); Rodgers, *The Corporate Trust Indenture Project*, 20 BUS. LAW. 551 (1965); Note, *Some Aspects of the Trust Indenture Act of 1939: Duties and Responsibilities of Indenture Trustees*, 18 CHI.-KENT L. REV. 406 (1940); Note, *The Trust Indenture Act of 1939: Limitations on the Trustee's Privilege of Lending to the Obligor*, 7 U. CHI. L. REV. 523 (1940); 25 CORNELL L.Q. 105 (1939); 28 GEO. L.J. 1084 (1940).

5. SEC Manual: Trust Indenture Act of 1939 (June 30, 1958) (unpublished) (copy on file with the *Vanderbilt Law Review*) [hereinafter cited as the SEC Manual].

6. *Reporter's Introductory Memorandum* to ALI FED. SEC. CODE (Tent. Draft No. 2, 1973) at xv.

7. ALI FED. SEC. CODE (Proposed Official Draft, 1978) [hereinafter cited as the 1978 Draft].

8. Friedman, *Updating the Trust Indenture Act*, 7 U. MICH. J.L. REF. 329 (1974).

that the corporate trust function be separated from other trust activities that might involve trading by the trustee in the obligor's stock.⁹ He expressed concern about the conflict presented when an indenture trustee becomes a lender to the obligor or an underwriter of the obligor's securities,¹⁰ but he did not recommend that the law be changed to make the trustee-lender relationship a disqualifying conflicting interest. He did suggest, however, that indenture security holders be entitled to share in preferential collection of claims by the trustee-lender if *any* default occurs, not just a default in the payment of principal and interest as TIA section 311¹¹ currently provides.¹² Finally, Friedman recommended that an indenture trustee be obligated by statute to exercise prudence in discovering defaults by the obligor.¹³

The second event that focused attention on the TIA was a proposal to define the trustee-lender relationship as a disqualifying conflict of interest, a proposal made at the last moment by an officer of the United States Trust Company of New York, one of the few banks in the United States that is primarily a trust company.¹⁴ Under existing law, an indenture trustee may also be a lender to the obligor on the indenture securities or to an underwriter of the obligor's securities.¹⁵ The proposal, which was not supported by Professor Loss, was defeated after extensive debate in the American Law Institute; consequently, it did not become part of the Code.¹⁶ Note, however, that both the Reporter and the American Law Institute declined to take a position on the merits of the proposal in the event it should be considered by Congress apart from the Code.¹⁷

This Article will summarize briefly the significant provisions of

9. *Id.* at 350-54. The Code leaves this matter to Rule 10b-5 concepts and to a provision regarding imputation. See 1978 Draft, *supra* note 7, §§ 287(c), 1603.

10. Friedman, *supra* note 8, at 340-44.

11. 15 U.S.C. § 77kkk (1976).

12. Friedman, *supra* note 8, at 354-56. Bankruptcy defaults were added by the Code in TD-4, *supra* note 3, § 1006(i)(2)(B), which is 1978 Draft, *supra* note 7, § 1307(i)(2)(B).

13. Friedman, *supra* note 8, at 356-57. See text accompanying notes 123-27 *infra*.

14. See 1978 Draft, *supra* note 7, § 1306(c), note (3), see TD-4, *supra* note 3, § 1005(c), comment (1). See generally Campbell & Zack, *Put a Bullet in the Poor Beast. His Leg is Broken and His Use is Past. Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: A Proposal to End it in the Public Interest*, 32 BUS. LAW. 1705 (1977); Shane, *Banks as Lender and Indenture Trustee*, BANKER'S MAG., Winter 1976, at 97. But see Letter from Robert I. Landau and Richard A. Stark to Professor Louis Loss (December 23, 1976) (unpublished copy on file with *Vanderbilt Law Review*); Memorandum from Davis, Polk & Wardwell to Professor Louis Loss (January 10, 1977) (unpublished) (copy on file with *Vanderbilt Law Review*).

15. See TD-4, *supra* note 3, § 1005(c), Comment (1).

16. See 1978 Draft, *supra* note 7, § 1306(c), Note (3).

17. *Id.*

the TIA as they currently are applied¹⁸ and will describe and comment upon Code Part XIII, Trust Indentures, as it appears in the 1978 Draft.

II. SUMMARY OF THE PRESENT LAW

A. Purpose

Investor losses during the Depression of the 1930's focused congressional attention upon the Nation's financial structures. Relying on federal jurisdiction over the mails and interstate commerce, Congress enacted the Securities Act of 1933,¹⁹ the Securities Exchange Act of 1934,²⁰ and the Public Utility Holding Company Act of 1935²¹ to regulate the securities markets. These acts, however, failed to reach effectively certain aspects of bonds and other securities issued under trust indentures.

The trust indenture has long been an important part of the mechanism by which business enterprises obtain long-term financing by sale of debt securities to the investing public.²² The indenture is a contract between the obligor and the trustee made for the benefit of the investors—the indenture security holders—and avoids the necessity of the obligor entering into complex individual contracts with each holder of its indebtedness. The contract vests certain powers and duties in the trustee with respect to the enforcement of the issuer's obligations and the indenture security holders' rights.²³ While the legal status of the indenture trustee has never been defined precisely, the terms of the indenture control the determination of the rights and duties of the obligor, the trustee, and the indenture security holders.²⁴ Prior to 1939, it was customary for trustees to minimize their obligations under indentures by including exculpatory clauses in the indenture.²⁵ Specific reform legislation was first recommended by the SEC in 1936.²⁶ In 1939 Congress responded

18. See generally L. LOSS, *SECURITIES REGULATION* 720-53 (2d ed. 1961 & Supp. 1969).

19. 15 U.S.C. §§ 77a-77aa (1976) [hereinafter referred to as 1933 Act].

20. Codified in scattered sections of 77 and 78, 15 U.S.C. [hereinafter referred to as 1934 Act].

21. 15 U.S.C. §§ 79-79z-6 (1976).

22. See *Introduction to AMERICAN BAR FOUNDATION, COMMENTARIES ON INDENTURES* 4-8 (1971) [hereinafter cited as *COMMENTARIES*]; J. KENNEDY & R. LANDAU, *CORPORATE TRUST ADMINISTRATION AND MANAGEMENT* 19-44 (2d ed. 1975).

23. 28 GEO. L.J. 1005, 1085-86 (1940).

24. 25 CORNELL L.Q. 105, 105-06 (1939).

25. SEC, *REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES*, Pt. VI, at 3-5 (1936) [hereinafter cited as *REPORT*]; Banks, *supra* note 4, at 533-34.

26. Banks, *supra* note 4, at 533-34. Part six of the *REPORT*, *supra* note 25, dealt with trustees and indentures.

with the TIA. The House and Senate reports contained the following statement of purpose of the TIA:

1. To provide full and fair disclosure, not only at the time of original issue of bonds, notes, debentures, and similar securities, but throughout the life of such securities.
2. To provide machinery whereby such continuing disclosure may be made to the security holders, and whereby they may get together for the protection of their own interests.
3. To assure that the security holders will have the services of a disinterested indenture trustee, and that such trustee will conform to the high standards of conduct now observed by the more conscientious trust institutions.²⁷

B. Statutory Scheme—Required and Permitted Indenture Provisions

The TIA requires that trust indentures relating to certain debt securities be "qualified" under the TIA. To become qualified, the indenture, meeting certain requirements, must be filed with the SEC together with a 1933 Act registration statement or an application for qualification, and the registration statement or application must become effective.²⁸ Generally, qualification of an indenture is required when a 1933 Act registration also is required, and the procedure under the two Acts is integrated in order to avoid unnecessary expense and delay.²⁹ A separate qualification procedure is provided for those few cases when qualification is required but 1933 Act registration is not.³⁰

The principal purpose of the TIA is accomplished by requiring that certain provisions be included in all indentures to be qualified and by permitting other provisions to be included. The SEC's administrative position has been that substitutions for and variations of permitted provisions cannot be inconsistent with the terms per-

27. H.R. REP. No. 1016, 76th Cong., 1st Sess. 25 (1939); S. REP. No. 248, 76th Cong., 1st Sess. 1-2 (1939). See generally *Reporter's Introductory Memorandum* to TD-4, *supra* note 6, at xix; L. Loss, *supra* note 18, at 720-25.

28. TIA §§ 305, 307, 309, 15 U.S.C. §§ 77eee, 77ggg, 77iii (1976).

29. See TIA §§ 305, 309, 15 U.S.C. §§ 77eee, 77iii (1976); S. REP. No. 248, 76th Cong., 1st Sess. 9-10 (1939). A district court has held that when the description of creditors' rights in the prospectus conflicts with provisions in the indenture, the indenture provisions are controlling. *In re Discon Corp.*, 346 F. Supp. 839, 844 (S.D. Fla. 1971). See also J. KENNEDY & R. LANDAU, *supra* note 22, at 77-78. In general, securities and transactions that are exempt from the 1933 Act or its registration requirements also are exempt from the indenture qualification requirements of the TIA. TIA §§ 304(a)(4), (5), (10), 304(b), 15 U.S.C. §§ 77ddd(a)(4), (5), (10), 77ddd(b) (1976). In a few cases, securities are exempt from the TIA, but are not exempt from the 1933 Act. TIA § 304(a)(6), 15 U.S.C. § 77ddd(a)(6) (1976) (debt issues by foreign governments); TIA § 304(a)(8)-(9), 15 U.S.C. § 77ddd(a)(8)-(9) (1976) (small issues).

30. TIA §§ 307, 309, 15 U.S.C. §§ 77ggg, 77iii (1976). Exchange of securities transactions exempted from the 1933 Act by § 3(a)(9)-(10), 15 U.S.C. § 77c(a)(9)-(10) (1976), are not exempt from the TIA.

mitted by the TIA.³¹ Thus, the TIA is implemented through required and permitted provisions in private contracts that can be enforced only through private litigation. The principal required and permitted provisions are summarized in sections II(E) through II(J) below.

C. *Applicable Law*

Legislative history suggests that Congress intended that disputes involving indentures be resolved in state courts pursuant to state contract and trust law.³² As SEC Commissioner William O. Douglas testified: "The indenture, after it has been 'qualified' under this statute, will be enforceable, in the same manner . . . that indentures presently executed are enforceable."³³ That indentures were to be enforced as private contracts by state courts applying state law was settled prior to the enactment of the TIA.³⁴

In 1975, however, a federal district court in *Morris v. Cantor*³⁵ held that the TIA created substantive liabilities for violations of the provisions of indentures qualified thereunder and that indenture security holders could enforce such liabilities as a matter of federal law in a federal forum.³⁶ In *Morris*, Interstate Department Stores, Inc. (Interstate), had issued convertible subordinated debentures under an indenture with Bankers Trust Company as trustee. The debentures were unsecured and subordinated to all "senior indebtedness" (as defined) of the issuer. The indenture provided that should the indenture trustee be or become a creditor of the issuer, the trustee would be entitled to the benefit of the subordination provisions of the indenture with respect to senior indebtedness to the same extent as any other holder of such indebtedness.³⁷

The complaint, brought by a protective committee, alleged that Bankers Trust, while trustee, acted as lead bank in negotiating the

31. SEC Manual, *supra* note 5, at 133-34. See also TIA § 318, 15 U.S.C. § 77rrr (1976).

32. See Dropkin, *Implied Civil Liability Under the Trust Indenture Act: Trends and Prospects*, 52 TUL. L. REV. 299, 322-23 (1978).

33. *Trust Indentures: Hearings on H.R. 10292 Before the Subcomm. on Interstate & Foreign Commerce of the House Comm. on Commerce*, 75th Cong., 2d Sess. 22 (1938) (testimony of SEC Commissioner William O. Douglas).

34. See *Hazzard v. Chase Nat'l Bank*, 159 Misc. 57, 287 N.Y.S. 541 (Sup. Ct. 1936), *aff'd*, 257 A.D. 950, 14 N.Y.S.2d 147 (1939), *aff'd*, 282 N.Y. 652, 26 N.E.2d 801 (1940), *cert. denied*, 311 U.S. 708 (1940); 24 U.C.L.A. L. REV. 131, 144-45 (1976).

35. 390 F. Supp. 817 (S.D.N.Y. 1975).

36. The *Morris* holding was recognized as a possibility in a footnote of *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 426 n.17 (1971). In *Lewis v. Marine Midland Grace Trust Co.*, 63 F.R.D. 39 (S.D.N.Y. 1973), the court permitted a plaintiff to amend his pleadings to include a civil cause of action based on the TIA.

37. 390 F. Supp. at 818.

extension to Interstate of a \$90,000,000 line of credit, which qualified as senior indebtedness with respect to the debentures. Bankers Trust thus became a preferred senior creditor of Interstate, with priority over the debenture holders, in the event of bankruptcy. The loan was not consummated until after Bankers Trust resigned as trustee and was not negotiated within four months prior to a default in payment of the principal or interest under the indenture. The protective committee contended, however, that the action of Bankers Trust constituted "willful misconduct" within the meaning of TIA section 315(d).³⁸

The court's jurisdiction was based exclusively on TIA section 322, which provides: "Jurisdiction of offenses and violations under, and jurisdiction and venue of suits and actions brought to enforce any liability created by, this subchapter, or any rules or regulations or orders prescribed under the authority thereof, shall be as provided in section 22(a) of the Securities Act of 1933 [15 U.S.C. 77v(a)]."³⁹ A claim of breach of fiduciary obligations to the debenture holders also was proffered.⁴⁰

In *Morris* the court framed the legal issues as follows: (1) does the TIA by its terms create any liability (within TIA section 322) for violation of the provisions of indentures qualified thereunder; and (2) does a civil right of action exist for indenture security holders to enforce such a right?⁴¹ After noting that these questions had never been decided by the courts, Judge Ward looked for guidance to the structure and legislative history of the TIA.⁴² The court noted that "the scheme of the Act [TIA] is to regulate in a limited fashion by taking a type of private contract, requiring that it contain certain terms and be registered with the Commission . . . and precluding the Commission from enforcing those terms."⁴³ Turning to the TIA's legislative history, the court acknowledged that the history did not speak directly to the question of creating liability for violation of indenture provisions. Nevertheless, Judge Ward was persuaded by his reading of the legislative material that the TIA creates substantive liabilities in those areas it specifically addresses.⁴⁴ Reasoning that the TIA "must be viewed as an indirect method of imposing nationally uniform and clearly defined obliga-

38. *Id.*

39. TIA § 322(b), 15 U.S.C. § 77vvv(b) (1976).

40. 390 F. Supp. at 818.

41. *Id.* at 818-19.

42. *Id.* at 819-22.

43. *Id.* at 819-20.

44. *Id.* at 820-22.

tions upon those associated with the issuance of corporate debt," the court held that the statute "created liability" as though it had directly required the same actions of trustees and obligors, and consequently, conferred jurisdiction upon district courts over suits to enforce that liability.⁴⁵ The existence of a private right of action was held to follow, a fortiori.⁴⁶

Finally, Judge Ward interpreted TIA section 315(d) as creating an area of residual liability for willful misconduct by a trustee, with misconduct to be defined by the common law as developed before and after the TIA.⁴⁷ The court concluded that the mere existence or creation of a dual relationship as trustee under the indenture and preferred creditor of the obligor on the debentures would not of itself constitute a violation of section 315(d).⁴⁸ The court recognized, however, that under particular factual circumstances the creation of such a relationship might be a violation of the statute; accordingly, the defendant's motion to dismiss the complaint was denied.⁴⁹

One commentator has suggested that "were *Morris* to come before a court today, it would probably be decided differently."⁵⁰ Relying on *Cort v. Ash*,⁵¹ this commentator reasons that before a federal cause of action for a statutory violation will be implied, an affirmative showing of appropriate congressional intent must be made.⁵² The TIA legislative history suggests that Congress did not intend that the TIA be enforced as a matter of federal law.⁵³ While *Morris* may have been wrongly decided, it seems unlikely that its result will be reversed in a later case. Although it may be bad law, it is clearly good policy.⁵⁴

D. The Role of the SEC

As indicated above,⁵⁵ the SEC is involved in the indenture qualification procedure, but after the qualification has become effective the SEC has no further power with respect to the indenture or the trustee. The SEC's power to issue a stop order is limited to the pre-

45. *Id.* at 822.

46. *Id.*

47. *Id.* at 823-24.

48. *Id.*

49. *Id.* at 824.

50. Dropkin, *supra* note 32, at 325.

51. 422 U.S. 66 (1975).

52. Dropkin, *supra* note 32, at 314-15.

53. *Id.* at 322-24.

54. *Id.* at 328. *In re Equity Funding Corp.*, 416 F. Supp. 161, 203 (C.D. Cal. 1976) follows the *Morris* holding.

55. See Part II(B) *supra*.

effective period.⁵⁶ TIA section 309(e) provides that nothing in the TIA shall be construed as empowering the SEC to conduct an investigation or other proceedings to determine whether provisions of a qualified indenture are being complied with or to enforce such provisions. The only enforcement mechanism is private litigation.⁵⁷

E. Mandatory Sharing and Preferential Collection of Claims

When the indenture trustee is also a creditor of an obligor upon the indenture securities, TIA section 311 prevents the trustee from improving its creditor position at the expense of the indenture security holders. The indenture must provide that if the trustee is or becomes a creditor of an obligor upon the indenture securities within four months prior to an uncured default, it must set aside in a special account an amount equal to any reduction of the debt made within that four-month period and also all property received as collateral. This fund is to be apportioned among the indenture security holders and the trustee in accordance with the formula set forth in TIA section 311(a). The TIA permits an indenture to exclude the following from these special account provisions: a creditor relationship arising from ownership of securities issued under an indenture or any securities having a maturity of one year or more at the time of acquisition;⁵⁸ certain ordinary course advances and

56. See TIA § 305(b), 15 U.S.C. § 77eee(b) (1967).

57. See S. REP. No. 248, 76th Cong., 1st Sess. 9 (1939). See also Part II(B) *supra*.

58. TIA § 311 (b)(1), 15 U.S.C. § 77kkk(b)(1) (1976). The meaning of the term "securities having a maturity of one year or more" in TIA § 311(b)(1) was considered in *United States Trust Co. v. First Nat'l City Bank*, 57 A.D.2d 285, 394 N.Y.S.2d 653 (1977). The United States Trust Company of New York, plaintiff and successor trustee under an indenture between the Equity Funding Corporation of America and First National City Bank, charged that while First National City was indenture trustee, it favored its interest as an individual creditor of Equity Funding over the interest of the indenture security holders and that defendant therefore was liable for an accounting and related relief. United States Trust argued that pursuant to TIA § 311, any payments received by defendant under a credit agreement and note within four months of Equity Funding's collapse were subject to the mandatory sharing provisions. Defendant contended that the credit agreement and note were not subject to the sharing provisions of the indenture because of the exclusion set forth in the indenture, permitted by TIA § 311(b)(1), for "securities having a maturity of one year or more." The court held that the credit agreement and note were not securities within the meaning of TIA § 311(b). Justice Silverman reasoned that the exclusion of "securities" held by the indenture trustee from the sharing requirements of section 311 was primarily intended to cover the case where the indenture trustee holds some securities out of a large public issue and where the indenture trustee's securities are treated the same as the vast majority of securities held by others and there is little or no opportunity or incentive for the indenture trustee to favor its individual interests over those of the debenture holders. Here the revolving credit agreement and the grid note represent a debt owed to four banks; and the indenture trustee, the defendant in this case, was the managing agent of those four banks in connection with that loan. The

disbursements; and certain other creditor relationships.⁵⁹ These mandatory sharing and preferential collection provisions are the alternative to disqualifying a trustee that becomes a lender to the indenture obligor.⁶⁰

F. Standard of Conduct

At the time of its enactment, TIA section 315, which prescribes the indenture trustee's standard of conduct, was a drastic change from the prior practice of providing limited responsibilities and broad exculpatory provisions for trustees.⁶¹ According to TIA section 315(a), an indenture may provide that *prior to default* the indenture trustee shall not be liable except for the performance of the duties that are specifically set out in the indenture and may rely conclusively upon certificates and opinions conforming to the requirements of the indenture.⁶² But no general standard of care is prescribed for predefault circumstances. TIA section 315(c) provides that the indenture shall contain provisions requiring the indenture trustee to exercise *in case of default* its rights and powers vested by the indenture and to use the same degree of care and skill in their exercise as a prudent man would use under the circumstances in the conduct of his own affairs.⁶³ Furthermore, an indenture may not contain a provision exculpating the trustee from liability for its negligent action, negligent failure to act, or willful misconduct except as expressly permitted by TIA section 315(d). The *Morris* case dealt with this provision.⁶⁴ In addition to those noted above in this section, permitted exculpatory provisions include: provisions pro-

loan was individually negotiated between defendant and Equity Funding; arrangements could be and were individually made for the protection of the defendant when insolvency was imminent

57 A.D.2d at 291, 394 N.Y.S.2d at 658. Accordingly, that portion of the lower court order dismissing the TIA § 311 causes of action was reversed.

59. TIA § 311(b)(2)-(6), 15 U.S.C. § 77kkk(b)(2)-(6) (1976).

60. See J. KENNEDY & R. LANDAU, *supra* note 22, at 65-68.

61. See *Dunn v. Reading Trust Co.*, 121 F.2d 854, 855 (3d Cir. 1941); *Banks*, *supra* note 4, at 539-41, 555-60.

62. See *Browning Debenture Holders' Comm. v. Dasa Corp.*, 431 F. Supp. 959, 962 (S.D.N.Y. 1976), *aff'd in part*, 560 F.2d 1078 (2d Cir. 1977) (in which the district court, relying on an indenture provision permitted by TIA § 315(a)(2), stated that the indenture trustee had no duty to form a judgment as to the fairness of a proposed reduction in the conversion price of the debentures and communicate that opinion to holders).

63. See *In re Multiponics Inc.*, 436 F. Supp. 1072 (E.D. La. 1977). In *Multiponics*, an indenture trustee sought reimbursement for services rendered by counsel it retained in connection with a reorganization proceeding. An analysis of which expenses were proper costs and expenses in connection with the administration is presented.

64. *Morris v. Cantor*, 390 F. Supp. 817, 823-24 (S.D.N.Y. 1975). See also Part II(C) *supra*.

protecting the indenture trustee from liability for an error of judgment made in good faith by a responsible officer without negligence in ascertaining pertinent facts; and provisions protecting the indenture trustee from liability for certain action taken or omitted in accordance with directions from the holders of a majority (in principal amount) of the indenture securities.⁶⁵

G. Eligibility and Disqualification of the Trustee

In addition to provisions relating to standards of conduct, the TIA contains provisions designed to assure that security holders will have the protection of a disinterested indenture trustee. Section 310 sets out standards for the eligibility and disqualification of indenture trustees. An indenture must require that there be at all times one or more trustees. At least one of the trustees must be a corporation organized and doing business in the United States with a combined capital and surplus of no less than \$150,000.⁶⁶ The corporation must be authorized to exercise corporate trust powers, and it must be subject to supervision or examination by a federal or state authority.⁶⁷ The indenture also must provide that if an indenture trustee has or acquires any conflicting interest, the trustee, within ninety days after ascertaining the conflicting interest, must eliminate the conflicting interest or resign.⁶⁸ In the nine subsections of TIA section 310(b), the principal provisions of which are summarized below, conflicting interests are defined.

According to TIA section 310(b)(1), the indenture trustee has a conflicting interest if it is a trustee under another indenture of the same obligor, except for specified circumstances in which no real potential for conflict exists.⁶⁹ An indenture may contain a provision excluding from the operation of TIA section 310(b)(1) other indentures under which other securities of the obligor are outstanding if one of the following is satisfied: (1) the indenture to be qualified and the other indenture or indentures are wholly unsecured, and the other indenture or indentures are specifically described in the indenture to be qualified; or (2) on application to the SEC, the issuer sustains the burden of proving that the trusteeship under both in-

65. TIA § 315(d)(2)-(3), 15 U.S.C. § 77000(d)(2)-(3) (1976).

66. TIA § 310(a)(1)-(2), 15 U.S.C. § 77jjj(a)(1)-(2) (1976).

67. *Id.*

68. TIA § 310(b), 15 U.S.C. § 77jjj(b) (1976). A mechanism for the removal of a trustee who fails to eliminate a conflicting interest or resign is set forth in TIA § 310(b). For discussions of the eligibility requirements for a corporate trustee, see J. KENNEDY & R. LANDAU, *supra* note 22, at 51-59; L. Loss, *supra* note 18, at 729-34.

69. TIA § 310(b)(1)(A)-(C), 15 U.S.C. § 77jjj(b)(1)(A)-(C) (1976); SEC Manual, *supra* note 5, at 12-14.

dentures is not likely to involve a material conflict.⁷⁰

A trustee is disqualified under TIA section 310(b)(2) if it or any of its directors or executive officers is an obligor (which includes a guarantor) upon the indenture securities or an underwriter for such obligor. If the trustee directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with an obligor upon the indenture securities or an underwriter for the obligor, then a conflicting interest exists under TIA section 310(b)(3). The test is actual direct or indirect control, a factual question to be determined on a case-by-case basis.⁷¹ TIA section 310(b)(4) provides that a conflicting interest exists if the trustee or any of its directors or executive officers is also a director, officer, partner, employee, appointee, or representative of an obligor or an underwriter for the obligor,⁷² but certain minimal director and/or executive officer interlocks are expressly permitted. Also, the trustee may act as transfer agent, registrar, custodian, depository, and the like for the obligor or an underwriter for the obligor. Restrictions are imposed on the beneficial ownership of the voting securities of the trustee by the obligor, the underwriters, and their respective directors, partners, and executive officers in TIA section 310(b)(5). Finally, TIA sections 310(b)(6)-(9) place restrictions on the trustee's ownership of the securities of the obligor. As noted above, the TIA does not define the trustee-lender relationship as a conflicting interest.

70. TIA § 310(b)(1)(i)-(ii), 15 U.S.C. § 310(b)(1)(i)-(ii) (1976); SEC Manual, *supra* note 5, at 12-14, 18-29b. In applying the rule against dual service as trustee and creditor, the SEC does not consider the term "trustee" to include affiliates of the institutional trustee. The SEC's general counsel has expressed the opinion that a trustee does not have a conflicting interest solely because it acts as trustee under indentures of both the obligor and an affiliate of the obligor. Trust Indenture Act Release No. 16, 11 Fed. Reg. 10,489 (1941); SEC Manual, *supra* note 5, at 14a-15.

71. See SEC Manual, *supra* note 5, at 32-36. The issue of control was considered at length by the SEC in *In re J.P. Morgan & Co.*, 10 S.E.C. 119 (1941). J. P. Morgan & Co. applied to the SEC for a finding that it did not have conflicting interests as defined in TIA § 310(b)(3) and (6). A possible conflicting interest arose because of the relationship between J. P. Morgan & Co. (indenture trustee) and Morgan Stanley & Co. (underwriter). Because of the community of interest of the proposed trustee and proposed underwriter stockholders, the court found common control. This position was abandoned when Morgan Stanley & Co. subsequently was converted into a partnership. See SEC Manual, *supra* note 5, at 36. It has never been raised since.

72. The SEC takes the position that whether the language "employee, appointee or representative" includes an attorney or a member of a firm regularly retained by the obligor or an underwriter for the obligor, if the attorney is an executive officer of a corporate trustee, will be disposed of on the merits of each case. SEC Manual, *supra* note 5, at 40-43.

H. Reports by the Trustee and the Obligor

In order to provide for continuing disclosure to security holders throughout the life of the indenture securities, TIA section 313 provides that an indenture must require the trustee to transmit to indenture security holders, at stated intervals, a brief report on the trustee's eligibility and qualifications under TIA section 310, the amount of any advances made by the trustee as trustee that remain unpaid on the date of the report if the advances aggregate more than a specified amount, a description of all other indebtedness of the obligor owing to the trustee in its individual capacity, property and funds physically in its possession as indenture trustee, any release or substitution of property subject to the indenture, and any action taken by the trustee in the performance of its duties under the indenture that in its opinion materially affects the indenture securities or the trust estate. The indenture also must require the trustee to give indenture security holders notice of all defaults known to the trustee within ninety days after the occurrence thereof, provided that the indenture may provide that notice may be withheld as to defaults on obligations not involving payment of money if directors and/or officers of the trustee in good faith determine that the withholding of notice is in the interests of the indenture security holders.⁷³

Obligors must be required by the indenture to file with the trustee copies of annual reports and other documents required to be filed with the SEC.⁷⁴ Also, the indenture must require that specified officers of the obligor, counsel, and other appropriate persons furnish the trustee with certificates or opinions as to the fair value of property released or deposited under the indenture, evidence of compliance with conditions precedent to the authentication of additional securities, and other specified matters.⁷⁵

I. Directions and Waivers by Indenture Security Holders

Under TIA section 316, an indenture may include provisions authorizing the holders of not less than a majority (in principal amount) of the outstanding indenture securities to direct the time, method, and place of exercising any power conferred upon the trustee or to consent to the waiver of any past default and its consequences.⁷⁶ An indenture also may contain provisions authorizing the

73. TIA § 315(b), 15 U.S.C. § 7700o(b) (1976).

74. TIA § 314(a), 15 U.S.C. § 77nnn(a) (1976).

75. TIA § 314(c)-(d), 15 U.S.C. § 77nnn(c)-(d) (1976).

76. TIA § 316(a)(1), 15 U.S.C. § 77ppp(a)(1) (1976).

holders of not less than seventy-five percent (in principal amount) of the outstanding indenture securities to consent on behalf of the holders of all such securities to the postponement of any interest payment for a period not exceeding three years.⁷⁷ TIA section 316(b) requires that an indenture provide that, with the exception of postponement of interest as mentioned in the previous sentence, the right of any security holder to receive his principal and interest and to bring suit therefor may not be impaired without his consent.⁷⁸

The provisions permitted by TIA section 316(a) may not be utilized to circumvent the mandatory provision in section 316(b) by directing the trustee not to bring any proceeding to enforce payment of principal and interest.⁷⁹ As noted above, the SEC's administrative position has been that substitutions for and variations of the optional provisions permitted by the TIA cannot be inconsistent with the terms permitted by the TIA.⁸⁰ For example, section 316(a) of the TIA permits the inclusion of indenture provisions authorizing the holders of specified percentages of indenture securities to take certain actions, and it is the SEC's position that all other provisions not consistent with those provisions are excluded.⁸¹ The SEC Manual states that "if this permissive provision is to have any meaning, it must have been intended to exclude all other provisions not consistent with its requirements."⁸²

J. Security Holder Communications

To make it possible for indenture security holders to communicate with each other for the protection of their interests, the indenture must require that the trustee provide three or more applying indenture security holders access to the names and addresses of other indenture security holders. The trustee, however, may mail the desired communication to all indenture security holders at the expense of the applying security holders.⁸³

77. TIA § 316(a)(2), 15 U.S.C. § 77ppp(a)(2) (1976). Including such a provision in indentures is not the general practice. *See, e.g.*, *Continental Bank & Trust Co. v. First Nat'l Petroleum Trust*, 67 F. Supp. 859, 871 (D.R.I. 1946); COMMENTARIES, *supra* note 22, § 9-1.

78. A subordination provision in an indenture is a manifestation of "consent." TD-4, *supra* note 3, § 1012(a), Comment (1).

79. *Continental Bank & Trust Co. v. First Nat'l Petroleum Trust*, 67 F. Supp. 859, 871-72 (D.R.I. 1946).

80. *See* SEC Manual, *supra* note 5, at 133-34.

81. *Id.*

82. *Id.*

83. TIA § 312(b), 15 U.S.C. § 77lll(b) (1976).

III. PROPOSED CODE PART XIII

A. *Statutory Scheme—Statutory and Optional Provisions*

The Code⁸⁴ preserves the essential features of the TIA indenture qualification requirement⁸⁵ as a part of the offering statement requirements of Part V.⁸⁶ The qualification becomes effective when the offering statement becomes effective.⁸⁷ Simplified requirements for an offering statement are provided for cases in which the transaction would have been exempt from the offering statement requirement except for the trust indenture aspects of the issue.⁸⁸ This avoids the complexity of TIA sections 306-308, which deal with indenture qualification when registration under the Securities Act of 1933 is not required.⁸⁹ The Code also deletes TIA exemptions that were not parallel to 1933 Act exemptions—the exemption for a security issued or guaranteed by a foreign government or a subdivision thereof and the exemption for small issues, it being noted by Professor Loss that the small issue exemption would be better dealt with by rule or order under Code section 303.⁹⁰

One of the principal changes to be effected by the Code relates to procedures by which required or permitted provisions are included in indentures. Code section 1305(a) designates provisions *required* to be included in an indenture as “statutory provisions” and considers them part of the indenture whether or not physically contained therein. Provisions *permitted* to be included in the indenture are designated “optional provisions” and are deemed included in indentures except to the extent specifically modified or excluded. Thus, the Code makes it unnecessary to set forth or mention in the indenture the “statutory” or “optional” provisions unless the latter are to be modified or excluded.⁹¹

84. In reviewing Part XIII of the 1978 Draft, reference should be made to the *Introduction* of the 1978 Draft, *supra* note 7, at xl-xlvii, the notes to Part XIII, the *Reporter's Introductory Memorandum* to TD-4, *supra* note 3, at xxi-xxviii, and the Comments to Part X of TD-4.

85. The terms “indenture,” “trust indenture,” and “indenture trustee” are defined in 1978 Draft, *supra* note 7, §§ 271, 273; TD-4, *supra* note 3, §§ 239, 241.

86. See 1978 Draft, *supra* note 7, §§ 1302, 1304. See generally, Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code*, 30 VAND. L. REV. 327 (1977).

87. 1978 Draft, *supra* note 7, § 1304.

88. See *id.* §§ 512(f)-(h), 515. See also note 29 *supra*.

89. *Introduction* to 1978 Draft, *supra* note 7, at xlv; *Reporter's Introductory Memorandum* to TD-4, *supra* note 3, at xxv; TD-4 *supra* note 3, § 501(e), Comment (1).

90. Compare 1978 Draft, *supra* note 7, §§ 303, 1303 and TD-4, *supra* note 3, §§ 302, 1001(d), Comments (6)-(7) with TIA § 304(a)(6), (8), (9), 15 U.S.C. § 77ddd(a) (6), (8), (9) (1976).

91. See 1978 Draft, *supra* note 7, § 1305; TD-4, *supra* note 3, § 1004, Comment (2). See also *Introduction* to 1978 Draft, *supra* note 7, at xl.

A similar scheme is used in the American Bar Foundation's *Model Debenture Indentures*, which provide for incorporation by reference of standard or model indenture provisions.⁹² The model indenture incorporating scheme, however, is not widely followed in indentures today because persons using indentures have found it cumbersome to refer back and forth between the principal document and the incorporated provisions, and some draftsmen have desired to make changes in the standard language. In commenting on the Code's provisions, Professor Loss has remarked that nothing will prevent the cautious from spelling everything out in an indenture.⁹³ Since indenture draftsmen tend to be cautious, one wonders how much practical effect this particular provision will have.

By mandating greater uniformity through the deemed inclusion of statutory provisions, the Code should simplify review by the SEC and others.⁹⁴ Although this may seem appealing, there will be a loss of the flexibility that the SEC has provided by permitting reasonable and practical variations from the TIA requirements on matters such as time periods and definitions.⁹⁵ Variations of statutory provisions will not be possible under the Code. It is doubtful, however, that this loss of flexibility will be a serious problem because the SEC will have authority to define statutory terms consistent with the purposes of the Code.⁹⁶ Furthermore, modifications of optional provisions will continue to be subject to SEC approval. In this connection, it is assumed that the SEC will continue its administrative interpretation that terms inconsistent with optional provisions are prohibited.⁹⁷

B. *Applicable Law*

Another principal change to be effected by the Code provides that "[a]n action that alleges a violation of or a failure to comply with a provision specified in Section 1305(c) is an action created by the Code"⁹⁸ Section 1305(c) states that "[t]he statutory provi-

92. See COMMENTARIES, *supra* note 22, § 1-1(a)(3).

93. *Introduction to 1978 Draft, supra* note 7, at xli; *Reporter's Introductory Memorandum to TD-4, supra* note 3, at xxi.

94. *Id.*

95. See, e.g., SEC Manual, *supra* note 5, at 59(a), 63, 69, 72, 78, 79, 80, 98, 108, 124, 130.

96. 1978 Draft, *supra* note 7, § 1804(a)(1).

97. See text accompanying notes 31 & 82 *supra*. Professor Loss has indicated informally that the Code is meant to continue the SEC position and that a comment to the Code to this effect may be added at a later date.

98. 1978 Draft, *supra* note 7, § 1719(a). No action within section 1719(a) may be brought more than (1) two years after the plaintiff knew or reasonably should have known the underlying facts, or (2) five years after the last act constituting the violation on which the action is based. *Id.* § 1727(e).

sions, the optional provisions, and any additional provisions of an indenture within section 1305(a) that are substantially the same as the statutory or optional provisions shall be interpreted, applied, and enforced exclusively as a matter of Federal law."⁹⁹ Thus, the Code would assure a uniform construction of statutory and optional provisions in indentures as a matter of federal law and in a federal forum if either party prefers it.¹⁰⁰ When the trust indenture provisions of the Code were being drafted in 1974, it was assumed, as noted above, that indenture provisions included under the TIA mandate were to be construed under state contract and trust law.¹⁰¹

Contrary to this assumption, the court in *Morris v. Cantor*¹⁰² reached the Code result on the basis of present law. Judge Ward rejected the indenture trustee's argument that the indenture was a private contract enforceable only in the state courts or in federal courts under diversity jurisdiction.¹⁰³ As previously discussed,¹⁰⁴ one commentator has raised the significant question whether the TIA legislative history justifies the *Morris* result. The Code will eliminate any further question on this topic by specifically incorporating the *Morris* holding into federal statutory law. The many contractual provisions that are neither statutory nor optional provisions will continue to be construed and applied as a matter of state law.¹⁰⁵ For example, Professor Loss observes that no federal usury law exists.¹⁰⁶

C. *The Role of the SEC*

A further significant change made by the Code relates to the SEC's enforcement authority. Under the TIA the SEC's authority ends at the time an indenture is qualified.¹⁰⁷ Additional enforcement is left exclusively to private actions. Under the Code the SEC will have the power to conduct an investigation to determine whether any person has violated, is violating, or is about to violate the

99. *But cf.* TD-4, *supra* note 3, § 1004(c), Comment (3) (reference to federal law does not preclude resort to state law precedents as persuasive).

100. *Introduction* to 1978 Draft, *supra* note 7, at xli; *Reporter's Introductory Memorandum* to TD-4, *supra* note 3, at xxi. 1978 Draft § 1822(a)(2) provides for concurrent jurisdiction by federal and state courts of all actions created by or based upon a violation of the Code.

101. *See Introduction* to 1978 Draft, *supra* note 7, at xli. *See also* text accompanying note 32 *supra*.

102. 390 F. Supp. 817 (S.D.N.Y. 1975). *See* text accompanying notes 35-54 *supra*.

103. 390 F. Supp. at 822.

104. *See* text accompanying notes 50-54 *supra*.

105. *Introduction* to 1978 Draft, *supra* note 7, at xlii-xliii; *Reporter's Introductory Memorandum* to TD-4, *supra* note 3, at xxiii.

106. *Id.* at xliii.

107. *See* Part II(D) *supra*.

Code.¹⁰⁸ Moreover, the SEC will have the power to bring an action not only to enjoin violation of the Code but also to enforce compliance with it.¹⁰⁹ For this purpose the Code includes statutory and optional provisions of indentures included pursuant to the Code.¹¹⁰ This important extension of SEC power does not include authority to conduct inspections of an indenture trustee's records in the manner that the Code authorizes for broker-dealers,¹¹¹ nor does it include the imposition of additional filing requirements.¹¹² Furthermore, the authority of the SEC remains limited in two respects: (1) the restriction on SEC investigation of a prospective indenture trustee is similar to TIA section 321(c);¹¹³ and (2) consistent with TIA section 305(b), stop-order proceedings are limited to the pre-effective period.¹¹⁴

Professor Loss explains the Code's expansion of SEC authority as follows:

Especially since it seems that nothing can be done about the two major substantive shortcomings of the Trust Indenture Act—permitting the institutional trustee to be a creditor of the obligor or underwriter, and limiting the statutory “prudent man” test so that it does not extend to the *discovery* of defaults . . .—it is the more important to provide for public enforcement of those protections that federal law does afford.¹¹⁵

Professor Loss also sees no justification for singling out the trust indenture portion of the Code for purely private enforcement.¹¹⁶

D. *Mandatory Sharing and Preferential Collection Provisions*

Several changes made by the Code in the mandatory sharing and preferential collection provisions are significant. First, a trustee may realize for its own account, free of the sharing provisions, on claims senior to the claim of the indenture securities,¹¹⁷ because such payments actually are not preferential and realizing on them is similar to realizing on secured claims as permitted by TIA section

108. 1978 Draft, *supra* note 7, § 1806(a).

109. *Id.* § 1819(a)(1).

110. *Id.* § 1305(c).

111. *See id.* §§ 1805(c)(1)(A), 1806(g)(1).

112. *Introduction to 1978 Draft, supra* note 7, at xlv; *Reporter's Introductory Memorandum to TD-4, supra* note 3, at xxiv-xxv.

113. *Compare* 1978 Draft, *supra* note 7, § 1806 (j) with TIA § 321, 15 U.S.C. § 77uuu (1976). The confidentiality requirements of TIA § 321(b) regarding reports on examinations by the SEC are substantially carried forward into the Code in 1978 Draft § 2004(e).

114. 1978 Draft, *supra* note 7, § 1808(e)(1).

115. *Introduction to 1978 Draft, supra* note 7, at xlv (reference omitted).

116. *See id.*

117. The term “indenture securities” is defined in 1978 Draft § 272 and TD-4, *supra* note 3, § 240.

311(a)(B).¹¹⁸ Professor Loss notes that this provision should have the beneficial effect of facilitating distress loans by the trustee.¹¹⁹ The SEC has allowed the inclusion of a provision to this effect so that it could be tested under TIA section 318(a) in a lawsuit,¹²⁰ but so far no such test suit has been brought.

Second, in apportioning the special account as between the trustee and indenture security holders, the Code authorizes the court to give indenture security holders priority on consideration of the seriousness of any breach of fiduciary duty that the court finds on the part of the trustee or any damage caused thereby.¹²¹ This change creates for the first time a penalty provision administered by the courts. Third, the definition of a "default" that activates the mandatory sharing provisions has been expanded to include, in addition to defaults on obligations to pay money, the institution of debtors' proceedings with respect to the obligor.¹²²

E. Standard of Conduct

As indicated above, TIA section 315(c) provides that a trustee is held to a "prudent man" standard in the exercise of its rights and powers only in post-default circumstances. The Code¹²³ does not go so far as to adopt Friedman's suggestion that trustees be made responsible for exercising prudence in discovering defaults, because the drafters were persuaded that to do so would be impracticable and prohibitively expensive in terms of increased trustees' fees.¹²⁴ The Code does require, however, that an indenture trustee be held to the prudent man standard in exercising its function and discharging its duties under Part XIII both before and after default.¹²⁵ Significantly, the Code preserves the effect of TIA section 315(a)(1) by providing as an optional provision that an indenture may provide that the trustee "is not liable, before it learns of an event of default, except for the performance of whatever duties are specifically set out in part XIII and the indenture."¹²⁶ Since it is likely that state courts would apply a prudent man standard to the predefault duties

118. Compare 1978 Draft, *supra* note 7, § 1307(b)(2) and TD-4, *supra* note 3, § 1006(b)(2), Comment (1) with TIA § 311(a)(2)(B), 15 U.S.C. § 77kkk(a)(2)(B) (1976).

119. TD-4, *supra* note 3, § 1006(b)(2), Comment (1).

120. SEC Manual, *supra* note 5, at 55.

121. 1978 Draft, *supra* note 7, § 1307(e); see TD-4, *supra* note 3, § 1006(e), Comment.

122. 1978 Draft, *supra* note 7, § 1307(i)(2)(B).

123. See *id.* § 1312.

124. Introduction to 1978 Draft, *supra* note 7, at xlv; Reporter's Introductory Memorandum to TD-4, *supra* note 3, at xxvi.

125. See 1978 Draft, *supra* note 7, § 1312(b).

126. *Id.* § 1312(c)(A).

of a trustee¹²⁷ even though not required by the TIA, the Code probably does not produce a significant change from present law.

F. Eligibility and Disqualification of the Trustee

The Code makes no substantive changes to TIA section 310(b) other than to extend the independence tests to any bank holding company or sister bank of the indenture trustee,¹²⁸ to limit the definition of underwriter to managing underwriter for purposes of determining the eligibility of the trustee,¹²⁹ to increase the minimum capital and surplus requirement to \$2,000,000,¹³⁰ and to empower the obligor, in addition to the indenture security holders (as under TIA section 310(b)), to bring an action for the removal of an ineligible or disqualified trustee.¹³¹ As discussed above,¹³² a proposal to include the trustee-lender relationship as a conflicting interest was not included in the Code.

G. Reports by the Trustee and the Obligor

The Code makes no substantive changes to TIA section 313, which requires that indentures contain provisions obligating the trustee to send certain brief reports to the indenture security holders.¹³³ The procedure is simplified, however, in that the trustee need not send to security holders a report that states only the trustee's belief that it continues to be eligible and qualified.¹³⁴ Filing a written statement to that effect with the SEC and each securities exchange on which the indenture securities are listed is sufficient.¹³⁵ The Code shortens from ninety days to six days after the trustee learns of the default the time within which an indenture trustee must give notice to indenture security holders of defaults on obligations to pay money.¹³⁶

A new provision has been added requiring the indenture obligor to send to the trustee, within ninety days after the end of its fiscal

127. See, e.g., *United States Trust Co. v. First Nat'l City Bank*, 57 A.D.2d 285, 294-97, 394 N.Y.S.2d 653, 660-61 (1977). See also *Dabney v. Chase Nat'l Bank*, 196 F.2d 668 (2d Cir. 1952).

128. 1978 Draft, *supra* note 7, § 1306(c).

129. See *id.* § 1306(g)(1)(B); TD-4, *supra* note 3, § 1005(g)(1)(B), Comment.

130. 1978 Draft, *supra* note 7, § 1306(a)(1)(E).

131. *Id.* § 1306(b)(3) & Note.

132. See text accompanying note 14 *supra*.

133. Compare 1978 Draft, *supra* note 7, § 1309 with TIA § 313(a), (b), (d), 15 U.S.C. § 77mmm(a), (b), (d) (1976).

134. 1978 Draft, *supra* note 7, § 1309(a)(1), (c).

135. *Id.* See also *id.* § 1309(c).

136. Compare *id.* § 1312(a) with TIA § 315(b), 15 U.S.C. § 77ooo(b) (1976).

year, a certificate of no default signed by a person who normally would be expected to learn of any default in the course of his duties and by an independent accountant in so far as compliance with conditions and covenants are subject to verification by accountants.¹³⁷ This change grew out of the review of the trustee's responsibilities prior to default that was encouraged by Friedman's article.¹³⁸ "No-default" certificates are a useful self-policing mechanism, and their expanded use in the Code is a logical development. The no-default certificate signed by a person who normally would be expected to learn of any default in the course of his duties is the general practice and is included in section 1006 of the American Bar Foundation's *Model Debenture Indenture*.¹³⁹ The requirement of an accountant's certificate is not included in the *Model Debenture Indenture* and is not in general use in trust indentures. An accountant's certificate, however, is sometimes found in trust indentures that include negative covenants or other provisions geared to accounting standards. It is also frequently found in agreements relating to private placements of debt securities and in bank loan agreements.

H. Application of the Code to Existing Open-End Indentures

Unless there is a post-Code distribution of securities under a pre-Code indenture, the pre-Code indenture and any pre-Code indenture securities will continue to be governed by the TIA. When a distribution of indenture securities is begun after the effective date of the Code pursuant to an indenture qualified before that date, however, Part XIII will govern with respect to all securities issued under that indenture whether distributed before or after that date.¹⁴⁰ This simple concept may create practical problems with existing open-end indentures (indentures that are designed to permit the issuance of additional indenture securities from time to time pursuant to amendatory or supplementary indentures) that include TIA-required and permitted provisions. If additional securities are distributed after the Code becomes effective, the statutory and optional Code provisions will become a part of the indenture in addition to the TIA provisions. Where the TIA and Code provisions are inconsistent, it seems clear that the Code provisions will control, since there is no protection against impairment of contract by fed-

137. See 1978 Draft, *supra* note 7, § 1310(a)(1)(B).

138. Friedman, *supra* note 8.

139. COMMENTARIES, *supra* note 22, at app. C § 1006(2).

140. 1978 Draft, *supra* note 7, § 2011(e)(3).

eral law.¹⁴¹ Determining when such an inconsistency exists, however, may be difficult. For example, the mandatory sharing provisions of TIA section 311 and Code section 1307 give indenture security holders a right to share in amounts collected by the indenture trustee as creditor within four months of default. Section 547 of the new Bankruptcy Code changes the preference period from four months to ninety days.¹⁴² Professor Loss has indicated that the period specified in Code section 1307 will be correspondingly changed.¹⁴³ Whether the holders of indenture securities issued prior to the effective date of the Code would be limited to ninety days pursuant to the Code rather than the four months specified in their indenture pursuant to the TIA could be a difficult question for the courts to resolve, since a provision giving security holders more than the Code requires may not be contrary to the Code.

To seek a solution to such problems by providing an exemption from the Code for pre-existing open-end indentures is not realistic. As a practical matter, a new indenture embodying the Code provisions could be created in many cases involving unsecured obligations, thus avoiding the transition problems that would be presented by a further securities issue under an existing open-end indenture. The continued use of existing open-end indentures, however, may be a necessity for the general mortgage obligations of most utility companies and railroad companies.¹⁴⁴ Thus, for further securities issues under open-end indentures, some significant technical and drafting problems are expected during the transition period.

I. Other Changes

The Code reflects numerous other changes of lesser importance, including the addition of a provision authorizing the trustee to vote as agent for the indenture security holders on an appointment of a trustee in bankruptcy to the extent the holders have not voted by a date set by the court.¹⁴⁵ A review of the Comments to the Code as it appears in both Tentative Draft No. 4 and the 1978 Draft will indi-

141. See U.S. CONST. art. 1, § 10; C. ANTIEU, MODERN CONSTITUTIONAL LAW §§ 326-33 (1969).

142. Compare Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 547(b)(4), 92 Stat. 2598 with 11 U.S.C. § 96(a)(1) (1976).

143. TD-4, *supra* note 3, § 1006 (a), Comment (1).

144. Until 1976, the TIA was not applicable to the indenture securities of rail carriers. See TIA § 304(a) (4) (A), 15 U.S.C. § 77ddd(a)(4)(A) (1976); 1933 Act § 3(a)(6), 15 U.S.C. § 77c(a)(6) (1976); S. REP. No. 595, 94th Cong., 2d Sess. 168, reprinted in [1976] U.S. CODE CONG. & AD. NEWS 148, 183.

145. See 1978 Draft, *supra* note 7, § 1314(c), TD-4, *supra* note 3, § 1013(c), Comment (2).

cate other areas where language has been modified to clarify and update the TIA.

IV. CONCLUSION

The Code requirement that statutory and optional trust indenture provisions are to be interpreted, applied, and enforced as a matter of federal law will be statutory confirmation of the *Morris* case. The overall scheme for dealing with trust indentures, trustees, and the related offering statement represents a desirable simplification and updating of the TIA provisions. Significantly, the SEC's enforcement authority regarding trust indentures is expanded to a level comparable with that provided in other areas of the securities laws. While the TIA is not generally thought to be in serious need of revision, Part XIII of the Code represents a thoughtful and practical reconsideration and codification of the TIA in the context of a revision and codification of all the securities laws.

